THE ECONOMIC OUTLOOK GROUP

475 Wall Street
PRINCETON, NEW JERSEY 08540 Tel: 609 - 529 - 1300
www.economicoutlookgroup.com

ECONOMIC TALKING POINTS

Bernard Baumohl
Chief Global Economist

January 5, 2016

Opportunities and Risks for the U.S. and World Economy in 2016

There's the story of a shopper who suddenly bumps into a friend he hasn't seen in years. As they happily greet each other, one of them asks a simple question. "Tell me in one word how you're feeling?" After a few seconds of thought, the other responds: "*Good*!"

Apparently not satisfied with that one-word answer, he rephrases the question. "This time tell me in two words how you feel." After a brief pause, the person responds: "*Not good!*"

In a sense that dual sentiment expresses how many of us may feel about the economy in 2016. While U.S. consumers and most businesses enter the new year in better financial shape and ready to ramp up spending, there are also several ominous risks looming overhead.

For example, the year got off to a shaky start after China reported more weak economic data, which then triggered a sharp drop in stock markets across Asia and Europe. Global nerves were also frayed by fresh tensions in the Middle East as Saudi Arabia and Iran exchanged fiery rhetoric and broke off diplomatic relations.

Here at home, the "R" word has begun creeping into more conversations lately and investors and business leaders are struggling to sort out how real that threat really is.

Clearly there's lots to ponder. Let me begin by addressing these concerns up front.

Look, the threat of geopolitical eruptions will remain a constant worry all year. There is no way around it. We live in a crisis prone world economy and decision makers will need to have contingency plans in place to mitigate any damage caused by exogenous shocks. I'll have more to say about this later.

But if we focus on the domestic economy, then I see no reason to be gloomy about the outlook. The risk of recession in 2016 is remote, less than 20%. Let's quickly dismiss some of the warnings that an economic downturn is near.

One line of thought is that the business cycle is tiring, aging, or long in the tooth.
Whichever metaphor you use, the fact is it's plain silly to employ the duration of an expansion as a forecasting tool for recession. It's true the US economy is now into its 7th year of recovery and that does exceed the post WWII average, which is less than 5 years. But this statistic tells us nothing about the internal strength of the U.S. economy. Business cycles simply do not end because of old age. To bring down an $18 trillion economy requires one or more events of sufficient magnitude to actually impede growth --- and that is not easy to do. I see no major economic impediments to growth in 2016, or for that matter in 2017.

Remember this recovery, which began mid-2009, never displayed any fireworks. Its comeback from the depth of the Great Recession has been the weakest in 70 years! That's because the last downturn was caused by overleveraging, a collapse in home prices, and deep financial failures. The economy still contains some scar tissue from that breakdown. Americans remain cautious about taking on new debt. Banks now scrutinize the creditworthiness of borrowers much more carefully before issuing loans. Businesses have been reluctant to invest in new capital equipment because overall demand has been soft and inventories are bloated. Indeed, the Fed's is still supporting this economy with a very accommodative monetary policy.

These are not the precursors of recession. The economy is not even close to overheating. So we believe the stage has been set for this business cycle to stretch on for several more years. At the very least, 2016 should be a better year than 2015 in terms of GDP growth, corporate profits and household income.

Why such optimism?

We'll begin with the most important segment of the economy in 2016, the consumer.

The best elixir for household spending is job and income security. Both have improved steadily last year and this paves the way for shoppers to accelerate spending this year.

In terms of employment, the pace of hiring has picked up significantly since last summer, when payrolls rose a monthly average 174,000 in the 3rd quarter. That has jumped to 254,000 so far in the final quarter of 2015. (December's employment report will be out at this Friday.) And the job market also shows no sign slackening. Employers have now posted a near record 5.4 million positions they seek to fill, up from 4.8 million a year ago.

Gains in the labor market have brought the jobless rate down to 5% in November, close to full employment. As a result, the competition to find suitable workers has been heating up, driving wages and salaries up by more than 4.5% over the past 12 months.
What counts most, though, is real disposable income, actual purchasing power. Take home pay adjusted for inflation has risen a solid 3.9% over the year.

Adding yet more fuel to the spending power of households is the wealth derived from their homes. Americans respond much more sensitively to changes in the value of their homes than their holdings in the stock market. They're well aware stock prices regularly fluctuate so its link to spending is a modest one. The movement in real estate values, however, has a much greater impact on spending behavior. The latest read from S&P Case-Shiller 20-Cities Index shows home prices have risen steadily in 2015 and is now up 5.6%, the largest annual hike since July 2014.

The result: Consumer moods have brightened considerably at the end of the year. Both major sentiment surveys showed Americans are upbeat about the economic outlook. The December read from the University of Michigan Sentiment index climbed to its highest since last July, while the Conference Board surprised analysts with a bigger than expected increase.

When you combine rising real income, home price appreciation and a more optimistic consumer, you have the ingredients for more vigorous consumer spending in the months ahead.

2106 Forecast:

--- U.S. GDP growth: 2.8% this year, and 3.0% in 2017

---Unemployment rate will drop to 4.8% at end of this year, and then edge up to 4.9% in 2017 as more Americans enter the labor force.

---Real disposable personal income is projected to increase 4.6% in 2016 and 5.1% for 2017.

--- The S&P Case-Shiller 20-Cities Home Price Index will rise 5.8% this year and 6.1% in 2017.

--- Real personal consumption expenditures is projected to increase from 2.8 % in 2015 to 3.2% for both 2016 and 2017. (We also see a generational shift away from purchasing goods to a preference for services, like travel and tourism, personal health improvement, and other kinds of experiential activities.)

Business investment spending

One area that has disappointed in recent years is capital expenditures. To some extent this is understandable. With the economy growing a mere 2% average the past five years, it's difficult for CEOs to get excited about escalating business investments. Moreover, manufacturers have seen export orders shrink due the weak growth abroad and the stronger dollar. Plummeting oil prices also forced energy companies to slash outlays for rigs, drills and other mining structures. The result has been a contraction in corporate profits last year.

Rather than re-invest earnings into their companies, many chose to by back shares and lift dividends to retain the loyalty of shareholders. But this strategy has some serious shortcomings too. Neglecting capital spending will hamper the ability of a company to generate organic growth in the future. Ultimately, it is capital spending that leads to creating real long term value.

That message will likely sink in this year. We're projecting an upturn in capital expenditures for the following reasons.

First, as the pace of hiring increases and labor becomes more expensive, firms will seek to offset these costs by investing in productivity-enhancing equipment. Failure to do so will further shrink margins.

Second, since we expect the dollar to remain fairly strong this year. U.S. exporters and domestic firms will have to compete against cheaper foreign products. To remain competitive in this tough global marketplace, companies will have to re-invest internally to improve operating efficiencies.

Third, years of neglect has left the business sector struck with an antiquated capital stock.. For example, the average age of the total US capital stock is now 22.3 years (oldest in 60 years). Manufacturing equipment alone is 23.2 years old (surpassing the 1946 peak), and communication structures are a record 20.3 years old. This represents just a partial list compiled by the US Commerce Department. These trends cannot continue indefinitely if companies want to be both competitive and profitable.

Fourth, given the geopolitical and national security challenges the U.S. faces, there is growing bi-partisan support to significantly beef up this country's defense capabilities. Greater military spending will spread across many other ancillary industries as well.

Fifth, we expect oil prices will bottom out in the low to mid-30s in the first quarter and then slope higher the rest of the year. As a result, most of the cutbacks in spending by energy firms have already occurred and that should diminish the headwind to GDP growth this year.

Finally, in terms of residential investments, we are encouraged by the overall improvement in housing fundamentals.

- Demand for homes will accelerate in 2016 as the economy, jobs and incomes continue to improve.

- Some 3 million young adults who have lived with their parents during the weak recovery years --- now want out! Thus we expect to see a sharp rise in new household formation this year.

- Mortgage rates will also remain historically low. Our forecast calls for the 30-year conventional loan to remain below 5% in 2016.

- Lenders have also relaxed on some mortgage requirements. While underwriting rules are now much more stringent than they were pre- crisis, the government has in recent months modified some of its regulations in an effort to revive the housing market, especially for first time homebuyers.

- On the production side, the lack of inventory will stir more homebuilding this year, especially now that access to construction capital has improved. The most difficult challenge for builders this year will be finding suitable land and hiring enough skilled labor to proceed with new construction.

2016 Forecast: % Real growth

Total non-residential fixed investments:
2015 = 3.4%
2016 = 5.6%
2017 = 5.0%

Total Equipment: % Real growth
2015 = 3.5%
2016 = 6.8%
2017 = 5.9%

Total residential fixed investment : % Real growth
2015 = 8.5%
2016 = 9.7%
2017 = 8.8%

Government outlays:

In late 2015, Congress and the President signed off on a two-year budget agreement that not only lessens the drag on economic growth imposed by sequestration but also ends the uncertainty over possible government shutdowns (at least until September 2017) and the debt ceiling (until March 2017).

The $1.15 trillion spending budget for FY 2016 will increase discretionary spending by $50 billion this year, split evenly between defense and nondefense. (Another $30 billion in discretionary spending is slated for 2017.) Aside from the increase in defense spending, the omnibus budget accord has allocated more money toward rebuilding America's highways and bridges, made permanent the R&D tax credit, funds the export import bank, allows for the faster depreciation write offs for small businesses, repealed the 40-year ban on oil exports, and much more.

We view this deal to be among the most productive bi-partisan budget agreements in half a decade and it should boost GDP growth this year by at least an additional by 0.25%.

Monetary policy.

On this topic, one principal theme emerges: Don't expect much from the Federal Reserve in 2016. The process of normalizing short term rates will take years!

The Fed finally acted last month with the first rate increase in nearly ten years. The quarter point increase lifted the effective target range to a whopping 0.38%.

From this point on, however, we expect it will be more interesting to watch grass grow than the upward movement of the fed funds rate. As we have said for sometime, the Fed will act to raise the benchmark rate just two more times this year. The next being in March or June, and the second in December. (FOMC documents following their December meeting suggest four rate increases in 2016, but we doubt that will happen.)

There are multiple reasons why we expect the Fed will keep it two hikes and end the year with a target rate of below 1%.

1. The divergence in global monetary policies among the central banks could lead to some severe dislocations. The Eurozone, Russia, China, and Brazil are some of the countries we expect will lower rates this year, while the US and UK are going to raise them. How will investors around the world react to this disparity? Will it trigger severe dislocations in foreign exchange markets, drain even more capital from troubled emerging countries and worsen recessionary conditions in those economies?

2. While the decision to raise rates at the December FOMC meeting was unanimous, will subsequent speeches and testimonies by Fed officials continue to show unanimity on monetary policy? Or will there be a split on what should happen next? Financial markets may not react well to mixed messages in this new interest rate regime.

3. If, as we expect, the US and international economy picks up speed in 2016, there is a chance that yields on Treasury notes and bonds could climb faster than anticipated. Sharply higher yields and a stronger dollar could magnify the tightening effects of monetary policy more than what the Fed intends. Should these events cool credit demand, derail the housing recovery and jeopardize the economic expansion, the Fed may have to quickly reverse course and lower rates again.

4. On the other hand, what if short-term rates rise faster than yields on longer maturities. A flat or inverted curve has been an extremely reliable predictor of recessions in the past. Banks would be reluctant to provide credit under such circumstances because net interest margins would shrink to levels that make lending more risky and far less profitable.

The Fed would then have two awkward choices: either return to a zero bound rate policy --- or sell off longer dated government debt from its balance sheets to increase supply in the secondary market. That could depress the price of notes and bonds and promote a rising yield curve.

5. Implementing monetary policy has gotten more complicated for the Fed. In the past, when banks sought to ramp up lending, they would often raise funds in the capital markets by selling shares or issuing debt. These intermediate steps took

time and that gave the Fed an opportunity to counter act all that credit creation and prevent sharply higher inflation.

But the Fed's reaction time has now been markedly reduced. Banks can more quickly tap their swollen reserves and convert them into fresh credit for lending to consumers and businesses. Out of an abundance of caution, the Fed may feel pressure to tighten monetary policy sooner than desired. But that could invite miscalculation and inadvertently trigger a recession.

6. Finally, let's throw in a little realpolitik here. With several leading Presidential candidates aggressively seeking to curb the Fed's independence, we suspect Janet Yellen and her colleagues would prefer to maintain a low profile during this election year.

Bottom line: Fed monetary policy will remain extremely accommodative this year with the "real fed funds rate" in negative territory lasting well into 2017.

Inflation:

Inflation will be on the move this year -- but peak out at a mild 1.5% by year end. There are several forces that should keep prices in check.

Commodity prices will remain subdued due to soft global demand and rising inventories. Secondly, the strong US dollar will not only continue to dampen import costs but also make it difficult for US producers to raise prices, lest they lose market share to foreign competitors. Third, interest rates will stay historically low and that should hold down borrowing costs for business. The one major factor that will nudge inflation higher this year will be the cost of labor.

The International Economy:

The US will continue to be the bright spot in the global economy in 2016. But we see encouraging signs of faster world GDP growth as well. Business conditions should stabilize, if not improve, for the Eurozone, Japan, Australia and even China as they all finally benefit from more monetary stimulus and low oil prices.

In particular, much attention will focus on China because it has served as a growth locomotive for so many other emerging economies. Its growth rate has steadily declined the last five years, and the economy will slow again this year to 6.5%, from 6.7% in 2015, as it works through high levels of debt and recessionary conditions in manufacturing and mining. But there are also some positive developments to consider. The country is making progress reducing its reliance on exports and heavy industry and giving a greater role for consumption and services.

In addition, home sales are rebounding, and the IMF has granted the renminbi special reserve status now that it's part of the Special Drawing Rights basket.

In short, China's leaders seem determined to continue the delicate task of allowing market forces to have a greater say in the allocation of capital. The challenge is whether a fundamentalist communist country can do so without destabilizing its economy and generating social unrest in the process.

Complicating matters is the bizarre dichotomy between a leadership that wants to give more ground to capitalism--- yet show absolute disregard for established international law by unilaterally proclaiming sovereignty over islands and seabeds in the East and South China Seas, tiny spots of land for which Beijing has no historical right to grab. It's the latter that could delay or undermine China's efforts to reform its economy.

The leaders, laggards and losers in the global economy in 2016.

- Leading the charge for real GDP growth this year will be the U.S., UK, India, Central Europe, Sub-Saharan Africa.

- The laggards --- nations likely to experience less impressive growth --- are China, Australia, Southeast Asia, Japan, Eurozone, Canada, and Mexico

- Those projected to be in or near recession this year are Russia, Brazil, and Venezuela. These countries have made their living principally selling basic commodities, continue to be burdened by excessive debt and massive corruption, and have shown little inclination to undertake needed structural reforms.

OK, so what could all go wrong with all these forecasts?
What reasonable threats lurk out there that could kill this recovery in 2016?

There is the sobering fact that terrorism, wars, cyberattacks, and the proliferation of weapons of mass destruction have become modern day threats to the world economy. More specifically, they can affect the U.S. in a number of ways.

1. Repeated acts of terrorism can unnerve consumers and investors. Americans, for example, may be more inclined to stay away from locations filled with people, like theme parks, stadiums, airports, shopping malls and subways. Such changes in behavior can curb spending and thus have a detrimental impact on the macroeconomy.

During periods of fear and instability, investors could abandon riskier assets, like stocks, and rush instead into safer ones, such as gold or treasury securities. Similarly, foreign investors may purchase more secure dollar-denominated assets, thereby pushing the greenback's value much higher. That can impact trade flows and even monetary policy.

2. Since the U.S. is now more integrated than ever into the global financial system, a geopolitical crisis half way around the world can quickly lead to a liquidity squeeze here at home. Liquidity, it has been said, is a coward, it disappears the instant there's trouble.

3. Geopolitical eruptions often are transmitted through sharp swings in the cost of crude. Sharply higher oil prices in the past have been responsible for pushing the U.S. into recession. It could happen again given the rotting political and military situation in the Middle East.

4. Foreign crisis can also threaten to disrupt supply chain networks. In that event, U.S. companies that rely on a global supply chain system could suffer lengthy interruptions in production, sales and earnings.

What risks should we monitor most closely this year?

Let's first look at some perils inside the U.S.

- A Federal Reserve miscalculation: Raising rates too soon can stall the economic expansion. Raising rates too late can lead to inflation and loss of confidence in Yellen.
Pressure then builds to hike rates more aggressively.

- The 2016 presidential campaign turns increasingly bizarre and troublesome. The uncertainty over future tax and spending policies, the direction of American foreign policy and, more broadly the unprecedented inflammatory rhetoric in this key election cycle could stall consumer and business spending and scare off investors.

- The danger of cyberthreat has never been greater. Business leaders, investors and households could find themselves defenseless if hackers disrupt US financial markets, shut down power grid, and ransack intellectual property.

Here are our top foreign threats that can potentially derail this recovery.

- **Saudi Arabia.** The chance of direct military confrontation between Saudi Arabia and Iran has escalated. Terrorists (and we include here both ISIS and Al-Qaeda) are also expected to be more determined to undo the Monarchy by sabotaging Saudi oil fields and destabilizing the Kingdom. Civil unrest inside the country surges. Oil prices climb towards $100 a barrel, even beyond.

- **China** adopts its own "Monroe Doctrine" policy in the Western Pacific. Its illegal seizure of islands in the East & South China Seas could culminate in a military showdown with U.S.

- **Russia:** Tensions over Ukraine and Syria worsen. Russia fills the political vacuum in the Middle East as the U.S. steps away. Vladimir Putin raises stakes further by threatening a NATO country. Article 5 draws U.S. into the conflict. Sanctions force Russia to default on its government debt; declares Force Majure to avoid consequences.

- **Iran.** The nuclear accord reached last year falls apart as Iran violates key provisions. Talk of an attack against Iran's key nuclear military installations takes on greater credibility.

- **North Korea** develops more sophisticated ICBM capability, with the ability to deliver nuclear warheads on American territory. The U.S. responds by taking more punitive military and economic actions against North Korea. Tensions along the Korean peninsula reaches its highest in more than half a century.

The list above is comprised of foreign threats we believe have at least a one in three chance of materializing.

Bottom line:

So, while we are more optimistic about U.S. and world economic growth for 2016, there is another daunting reality that commands equal attention. The global geopolitical pot is now boiling furiously and the eruption of one or two major crises in 2016 can certainly deflate consumer and business spending in the U.S. and elsewhere. This is the environment we now live in and it poses major new challenges on how to smartly allocate capital and preserve asset values.

Forecast tables below:

Key Economic Forecasts

- Actual
- Forecast

United States

	I 2015	II 2015	III 2015	IV 2015	I 2016	II 2016	III 2016	IV 2016	I 2017	II 2017	III 2017	IV 2017
Real Gross Domestic Product (GDP):												
%	0.6	3.9	2.0	2.4	2.6	3.2	3.1	2.7	2.2	3.2	3.1	2.8
Personal Consumption Expenditures:												
PCE	1.8	3.6	3.0	2.9	2.5	3.5	3.2	2.9	2.8	3.2	3.0	2.8
Inflation, end of period, year-over-year:												
CPI %	-0.1	0.1	0.0	0.6	0.8	1.2	1.5	1.6	1.6	1.9	2.2	2.3
Unemployment Rate (end of period):												
%	5.5	5.3	5.1	4.8	4.9	5.0	5.0	4.8	4.9	4.8	4.9	4.9
Non-farm Payrolls, monthly avg. thousand:												
	195	231	174	245	225	240	245	250	225	240	220	210
Treasury 10-yr Note Yield % (end of period)												
	1.93	2.38	2.06	2.27	2.50	2.65	2.88	3.10	3.10	3.10	3.15	3.30
Federal funds rate % (end of period)												
	0.13	0.13	0.13	0.38	0.63	0.63	0.63	0.88	1.13	1.38	1.63	1.88

GDP Growth - Global Economy

Country	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
US	1.8	-0.3	-2.8	2.5	1.6	2.2	1.5	2.4	2.5	2.8	3.0
Eurozone	2.6	0.6	-4.1	1.7	1.4	-0.6	-0.4	0.9	1.3	1.6	1.8
United Kingdom	3.1	0.6	-5.2	1.7	0.7	0.3	1.8	3.0	2.3	2.5	2.6
Japan	2.1	-0.7	-5.4	4.6	-0.4	1.6	1.5	-0.1	0.6	1.0	0.6
Canada	2.7	0.7	-2.8	3.2	2.5	1.7	2.0	2.4	1.1	1.8	2.1
India	9.1	8.8	6.3	8.4	8.6	6.7	4.9	7.4	7.3	7.5	7.8
China	14.2	9.6	9.2	10.5	9.5	7.8	7.7	7.3	6.7	6.5	6.5
Brazil	5.7	5.1	-0.3	7.5	2.7	0.9	2.3	0.1	-3.5	-1.8	1.1
Mexico	3.3	1.4	-4.7	5.2	4.0	3.9	1.4	2.1	2.3	2.4	2.8
Australia	4.0	2.3	1.2	2.8	2.6	3.6	2.4	2.7	2.3	2.8	3.2
Russia	8.1	5.6	-7.9	4.0	4.3	3.4	1.3	0.6	-3.6	-1.0	0.3
World	5.4	1.6	-1.9	4.2	3.0	2.6	2.9	3.0	2.8	3.1	3.7

Key Currency Values

	End 2008	End 2009	End 2010	End 2011	End 2012	End 2013	End 2014	End 2015	End 2016	End 2017
USD/Yen	91	93	81	77	87	105	119	120	121	130
Euro/USD	1.40	1.43	1.34	1.29	1.32	1.37	1.21	1.09	1.11	1.18

Oil (Brent spot) & Gasoline (Average retail unleaded, $)

	End 2008	End 2009	End 2010	End 2011	End 2012	End 2013	End 2014	End 2015	End 2016	End 2017
Crude oil per barrel	46	78	95	107	111	111	58	38	53	67
Gasoline	1.61	2.57	3.00	3.27	3.30	3.32	2.26	2.00	2.28	2.55

Major Stock Indexes

	End 2013	End 2014	End 2015	% Change '15	End 2016	% Change '16
DJIA	16,577	17,823	17,425	-2.2	19,875	14.1
S&P 500	1,848	2,059	2,044	-0.7	2,277	11.4
NASDAQ	4,177	4,736	5,007	5.7	5,435	8.5
RUSSELL 2000	1,164	1,205	1,136	-5.7	1,249	9.9